

THE FOREIGN TAX CREDIT: SECTION 902 AND THE UNITED KINGDOM CONVENTION

The recent case of *National Cash Register v. United States*¹ has raised several interesting questions about the foreign tax credit granted to domestic corporate shareholders in foreign corporations under the Internal Revenue Code² (both before and after the Revenue Act of 1962³), and its relationship with the Tax Convention credit between the United States and the United Kingdom.⁴ The National Cash Register Company (NCR), a United States corporation,⁵ owned and held all of the voting stock in two United Kingdom subsidiaries, The National Cash Register Company Ltd. and The National Cash Register Manufacturing Ltd. In 1958 under the pre-1962 foreign tax credit⁶ both subsidiaries repatriated earnings by paying the domestic corporation "dividends"⁷ out of their "accumulated profits"⁸ for the fiscal year of 1958. In computing its tax obligation for fiscal year 1958, NCR employed the direct credit of the "Convention" for the British "standard tax" pertaining to the dividend it received and used the indirect credit of the pre-1962, Section 902 (a) (1) in order to credit the "standard tax" relative to the undistributed profits. NCR also employed Section 902 to obtain a credit for the United Kingdom "profits tax" and other miscellaneous taxes that were incurred by the subsidiaries. As a result of NCR's tax return for 1958, the Internal Revenue Service claimed a deficiency against NCR for the amount which the corporation had credited for taxes relating to the undistributed portion of both of the subsidiaries' "accumulated profits." In a suit to regain the taxes paid pursuant to the deficiency⁹, NCR relied upon the words of both Section 902 and Article XIII (1) of the "Convention." Because the terms of the "Convention" made no reference to the remaining "standard tax"¹⁰ and the taxes

¹ 400 F.2d 820 (6th Cir. 1968).

² INT. REV. CODE, § 902 (a) (1) (1962), *amending*, INT. REV. CODE OF 1954, § 902 (a) (1).

³ See *Staff of House Comm. on Ways and Means*, 87th Cong., 2d Sess., LEGISLATIVE HISTORY OF THE REVENUE ACT OF 1962 (Comm. Print 1967).

⁴ The "Convention" has not been given an official name. It has been identified as "a convention between the United States of America and the United Kingdom of Great Britain and Northern Ireland, for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed at Washington on April 16, 1945," S. REP. NO. 4, 79th Cong., 2d Sess. 1 (1946) [hereinafter, "Convention"].

⁵ E. OWENS, THE FOREIGN TAX CREDIT (1961); INT. REV. CODE OF 1954, § 7701 (a) (4) & (10).

⁶ INT. REV. CODE OF 1954, § 902 (a) (1).

⁷ "Dividends", for the purpose of a 902 credit are those defined by U.S. law: Edward D. Untermeyer, 34 B.T.A. 906 (1932), *aff'd per curiam*, 59 F.2d 1004 (2d Cir. 1932), *cert. denied*, 287 U.S. 647 (1932).

⁸ For the definition of "accumulated profits", see INT. REV. CODE OF 1954, § 902 (c) (1).

⁹ *National Cash Register v. United States*, 270 F. Supp. 930 (S.D. Ohio 1967).

¹⁰ Article XIII of the "Convention," as amended in 1958, provided that:

covered by the Section 902 credit were so inclusive,¹¹ the district court permitted the NCR formulas in obtaining its credit. The appellate court, however, reversed this decision. Stating that the purposes behind both the "Convention" and the Code provisions were "to avoid the incidence of double taxation by different nations of the same dividends"¹², the court held that Article XIII of the "Convention" and Section 902 were mutually exclusive with regard to the "standard tax." Because the United States taxes only the dividend, and not the undistributed profit, the court stated that there was no danger of international double taxation with respect to those retained earnings.¹³ The appellate court relied upon the formula recommended by the Service whereby NCR would use the Section 902 credit for all the taxes levied against its subsidiary corporations. This formula, as counsel for the corporation stated, would result in more of a tax savings to NCR than would have resulted from the integrated use of the "Convention" credit for the British "standard tax" and the 902 tax credit for the "profits tax" and the miscellaneous taxes¹⁴ (because of the court's holding, it is assumed that the "standard tax" relating to undistributed profits is excluded from the calculations). The mechanics and policies underlying both the "Convention" and the pre-1962 foreign credit of Section 902 will be considered in this note. In addition, the Revenue Act of 1962 and its effects on the 902 credit will be analyzed in order to show its impact on foreign investments today.

I. THE UNITED STATES-UNITED KINGDOM TAX CONVENTION: A CREDIT FOR THE BRITISH STANDARD TAX

The general income tax of the United Kingdom is termed the British "standard tax." It is imposed at a flat rate of 38.75 percent on both the corporation and the individual.¹⁵ In order to accomplish this one-shot

(1) Subject to Sections 901 to 905 of the United States Internal Revenue Code as in effect on the 1st day of January 1956, United Kingdom tax shall be allowed as a credit against United States tax. For this purpose

(a) the recipient of a dividend paid by a corporation which is a resident of the United Kingdom shall be deemed to have paid the United Kingdom tax appropriate to such dividend . . .

if the recipient of the dividend . . . elects to include in his gross income for the purposes of United States tax the amount of such United Kingdom income tax.

Supplementary Protocol with The United Kingdom of Great Britain and Northern Ireland, August 19, 1958, 9 U.S.T. 1329, 1331, T.I.A.S. No. 4124.

¹¹ INT. REV. CODE OF 1954, § 902 (a) (1) refers to the taxes covered as "any income, war profits, or excess profits taxes. . . ."

¹² *United States v. National Cash Register*, 400 F.2d 820, 825 (6th Cir. 1968).

¹³ *Id.* at 826.

¹⁴ *National Cash Register v. United States*, 270 F. Supp. 930, 938 (S.D. Ohio 1967).

¹⁵ "Every body of persons shall be chargeable to tax in like manner as any person . . . Body of persons means any . . . company . . . whether corporate or not corporate." Income Tax Act, 1918, § 8 & 9, Geo. 5, c. 40. § 1; for a further discussion of the mechanics of the British tax system, see W. BRUDNO, *TAXATION IN THE UNITED KINGDOM* (1957) and E. KONSTAM, *THE LAW OF INCOME TAX* (12th ed. 1952).

method of taxing corporate profits, the British corporation is not permitted to deduct dividends paid to its shareholders in determining the taxable income against which the tax rate is applied. Instead, the corporation, in paying the dividend, is entitled to deduct an amount of the "standard tax" paid that is proportionate to the dividend.¹⁶ The amount "appropriate" is taxed at the "standard rate for the year in which the amount payable becomes due."¹⁷ By deducting this amount from the dividends being received by the shareholder, a corporation is, in effect, placing part of the tax burden levied against a corporation on the shareholder. A corporation will still be responsible for that portion of the "standard tax" relating to its undistributed profits.

In declaring the dividend, a British corporation may either declare itself "free of standard tax" or "with deduction of standard tax."¹⁸ The difference between the two is not significant except for the fact that each requires a different bookkeeping entry for the shareholder. Since the shareholder is required to include the tax appropriate to his dividend in his gross income, it is necessary to know or be able to compute that amount. When the dividend is declared "free of the tax," the net amount is the declared dividend and the amount of the appropriate "standard tax" is not shown. On the other hand, when a dividend is declared with a deduction, at the time of payment, the corporation advises the shareholder of the gross amount of the dividend, the rate, and the amount of income tax "appropriate" to the gross amount of the dividend and the net amount actually paid.¹⁹

Since a dividend declared free of the tax does not indicate the gross amount from which the shareholder can compute the tax, it is provided that the amount received "shall . . . be deemed to be a net amount received in respect of a dividend from the gross amount of which such deduction as is authorized by the said rule . . . has been made." Using this amount, the British taxpayer must employ a calculation whereby the amount received is "grossed up" to be the amount of the dividend with the inclusion of the "standard tax."²⁰ In both cases, the shareholder is then deemed to have received the gross amount of the dividend and must include it in his total income.²¹ If the shareholder's total income is less than £2000 (a level at which he will become liable to a surtax²²) his tax, because of al-

¹⁶ Income Tax Act, 1918, 8 & 9 Geo. 5, c. 40.

¹⁷ Finance Act, 1927, 17 & 18 Geo. 5, c. 10, § 39(1).

¹⁸ National Cash Register v. United States, 400 F.2d 820, 824 (6th Cir. 1968).

¹⁹ Finance Act, 1924, 14 & 15 Geo. 5, c. 21, § 33.

²⁰ Finance Act, 1940, 3 & 4 Geo. 6, c. 29, § 20; The formula for "grossing up" the dividend for British tax purposes is: $\frac{d}{1 - r}$ (dividend) (rate of the tax).

²¹ Finance Act, 1927, 17 & 18 Geo. 5, c. 10, § 39(2).

²² Finance Act No. 2, 1945, 9 & 10 Geo. 6, c. 13, § 15.

lowances, may be less than the tax deemed to have been paid on the dividend received by him, and he is accordingly entitled to a repayment of tax.

The interpretation given to this corporate-individual taxation system by the United States courts prompted the inclusion of Article XIII (1) into the "Convention." In *Biddle v. Commissioner*,²³ a United States citizen owning stock in a British corporation sought to obtain a credit for the British "standard tax" proportionate to the dividends he had received through the antecedent form of Section 902 (a) (1), the direct credit of Section 131 (a) (1) of the Code. The petitioner contended that he had paid the British "standard tax" withheld by the corporation from the dividend and should, therefore, be entitled to a credit for the "standard tax."

The Supreme Court held that the taxpayers were not entitled to a credit since the corporation had paid the tax, notwithstanding the fact that its taxpayers' dividends were lessened by the amount proportionate to the tax. It was held that the meaning of "taxes paid" in Section 131 (a) (1) was to be determined according to United States law and not by reference to foreign decisions.²⁴ (English courts had held that the shareholder is regarded as having paid the "standard tax" by the deductions from his dividend). Thus, the Court placed a technical rather than a substantive test on who paid the tax.

Under the "Convention," the taxpayer is deemed to have paid the "standard tax" appropriate to the dividend if he elects to include the amount of the tax in his gross income.²⁵ In effect, the United States taxpayer is required to include the "grossed-up" amount of the dividend he has received in his taxable income. The tax computed at the United States corporate rate is then credited with the amount of the "standard tax" (an example of these calculations using the "grossed-up" methods of calculations will be given in the subsequent discussion of the 1962 Revenue Act).

While the *Biddle* decision prohibited the use of the direct credit afforded by Section 901 for a standard tax credit, it did not preclude use of the Section 902 (a) (1) indirect credit granted to a corporate shareholder owning a minimum of 10 percent of the stock.²⁶

II. THE INDIRECT CREDIT OF SECTION 902: PRE-1962 LEGISLATION

The United States has long recognized a need for some unilateral action on its part in order to place the foreign income recipient who is a citizen of this country, on an equal footing with the rest of the American taxpayers. Since its tax system bases susceptibility to taxation on the

²³ 302 U.S. 573 (1938).

²⁴ *Id.* at 581.

²⁵ Alexander, *The Income Tax Convention With The United Kingdom*, 2 TAX L. REV. 295, 324-25 (1947).

²⁶ INT. REV. CODE OF 1954, § 322 (a) & (b).

status of the income recipient as well as the source of his income,²⁷ a United States citizen is taxed on his global income regardless of whether he resides in this country or whether the income he received was earned in this country. United States corporations, with few exceptions,²⁸ have been treated similarly.

In an effort to eliminate the "double taxation" that resulted from the U.S. tax laws, Congress in 1918 allowed an individual taxpayer, at his election, to claim a credit, as well as the deduction, for foreign taxes paid.²⁹ Thereafter, in response to efforts at increasing investment opportunities abroad, Congress amended the statute to allow a domestic corporate shareholder to claim a credit for foreign income taxes paid by it as well.³⁰ As this foreign credit for such domestic corporations developed, it became known as an "indirect credit" in the sense that it was a credit for taxes paid indirectly by a qualifying taxpayer. The rationale of an indirect credit is that a corporate shareholder of a foreign corporation "pays" the foreign tax imposed on the foreign corporation through a reduction in its dividend income.³¹ The indirect credit has been criticized because it not only permitted the common shareholder but also the *preferred* investor to claim the credit. This criticism is based on the theory that a corporate shareholder of common stock is the taxpayer of the foreign tax in that the amount of his dividend is partially determined and reduced by the foreign tax levied against the foreign corporation. Unlike the common shareholder, however, the preferred always receives the same return regardless of the tax and, therefore, he should not be permitted to reap the benefits of the credit.³²

The characteristic of the foreign tax credit for corporate shareholders that raised the most controversy and which led to the enactment of Section 9 to the Revenue Code of 1962 was that the corporate shareholder could obtain a more beneficial credit than could the individual taxpayer.

Unlike the credit afforded by the "Convention" and the credit given under Section 901, where the "grossed-up" dividend is included in the taxpayer's gross income, Section 902 prior to 1962 permitted the profits out of which the dividends were paid to the shareholders to be automatically reduced by the amount of the foreign tax paid. In other words, the net amount of the dividend was included in the taxpayers income and became

²⁷ Owens, *Role of U.S. Income Tax Treaties In Relieving Double Taxation*, 4 INSTITUTE ON PRIVATE INVS. ABROAD, 109, 114 (1962).

²⁸ For some exceptions see INT. REV. CODE OF 1954, §§ 911, 931, 933, 943.

²⁹ Revenue Act of 1918, c. 18, §§ 222, 239, 40 Stat. 1973.

³⁰ Surface, *Grossing Up — A Step Toward Non-Recognition of a Foreign Subsidiary As A Corporate Entity*, 15 U. FLA. L. REV. 555 (1962).

³¹ E. Owens, *supra* note 5 at 93.

³² *Id.* at 97-99.

subject to the corporate rate of taxation while the amount not included in the gross income was taxed at the foreign rate.³³

The effect of carrying over the net dividend instead of the "grossed-up" amount was that the combined United States and foreign rates of tax on the entire pre-tax earnings of the foreign subsidiary could be substantially less than the United States rate. The variation was not uniform and, taking 52 percent as the United States corporate tax rate,³⁴ the tax saving reached its maximum when the foreign tax equaled 26 percent.³⁵ At that rate, combined U.S. and foreign taxes would be approximately 45 percent rather than 52 percent. As the foreign rate moved away from 26 percent in either direction, the gap between the 52 percent United States corporate rate and the actual combined U.S. and foreign rate on the dividend narrowed, and the gap actually would disappear if the foreign rate was either 52 percent or zero.³⁶

Prior to the *American Chicle* case,³⁷ the benefits derived from Section 902 were even greater. The corporate shareholder was permitted to credit that portion of the foreign tax paid which the dividends received bore to the "accumulated profits" from which they were paid. Since the accumulated profits were the profits remaining after all taxes had been paid,³⁸ and were the source of all dividends they would all eventually be paid out in dividends permitting the taxpayer a full credit of the foreign taxes paid by the subsidiary.³⁹ For example, if the profits of a foreign corporation were \$1000 with a foreign tax of \$400 and accumulated profits of \$600 which were paid as dividends to the United States corporate shareholders, the \$400 in taxes multiplied by the proportion of the dividends to the "accumulated profits" (resulting in a factor of one) would be fully credited against the taxpayer's U.S. taxes.

The reason for this full credit was that of the \$1000 in foreign profits, only \$600 was subject to tax in the United States and it was only part of the foreign tax imposed on the same amount of income, *i.e.*, \$600 which is entitled to be credited. So far as the remaining \$400 of profits earned in

³³ *Id.* at 113.

³⁴ The corporate tax rate in the United States is now 48 percent on income over \$25,000 plus the 10% surtax.

³⁵ Stone, *U.S. Taxation of Profits Withdrawn From Foreign Corporations Under The Revenue Act of 1962*, 5 INSTITUTE ON PRIVATE INVS. ABROAD 85, 88-89 (1963).

³⁶ The consequences of this credit — granting relief to one as compared with another solely by reason of differing foreign tax rates — were clearly in opposition to any equitable theory of taxation.

³⁷ *American Chicle v. United States*, 316 U.S. 450 (1942); *International Milling Co. v. United States*, 27 F. Supp. 592 (Ct. Cl. 1939); *Eastman Kodak Co. v. United States*, 48 F. Supp. 357 (Ct. Cl. 1943).

³⁸ See note 8, *supra*, and accompanying text.

³⁹ The pre-*Chicle* formula was:

$$\begin{array}{l} \text{total taxes for foreign} \\ \text{corporation} \end{array} \times \frac{\text{dividend received}}{\text{"accumulated profit"}} = \text{tax credit}$$

the foreign country is concerned, no double taxation had occurred and therefore an extra fraction was needed whereby the amount of the taxes to be credited should bear the same proportion as did the "accumulated profits" to the total profits before any foreign taxation.⁴⁰ The "accumulated profits" in the numerator of the second fraction and in the denominator of the first cancel each other out, so the fraction, dividend/total profits, is multiplied by the taxes paid by the foreign corporation. Using the previous example, we find that instead of the \$400 in taxes being multiplied by a fraction of one (or something smaller if all of the "accumulated profits are not distributed), the dividend is reduced because a smaller fraction being employed, *i.e.*, \$600/\$1000.

Even with the *Chicle* factor, however, there was an element of tax-saving in the use of the indirect credit by a corporate shareholder. The effect of the initial deduction of the foreign tax amount from income subject to the U.S. tax still offset the slight attempt to increase the amount of taxes to be paid on the dividend by the *Chicle* fraction.⁴¹

It was this saving feature that prompted NCR to attempt such a credit with regard to the "standard tax" levied against the undistributed profits of its British subsidiaries as well as its use in computing the credit for the "profits tax" and other miscellaneous taxes.⁴² However, it appears that NCR had attempted to increase this already beneficial credit even more by "grossing-up" its dividend with the amount of the standard tax applicable to the dividend as is required in order to employ the "Convention" credit. Although this "grossed-up" dividend was used for the credit calculations in the formula, it was not added to NCR's taxable income as required by the credit of the "Convention." By doing this, a larger fraction against which these taxes were multiplied caused a larger credit which was not offset at all by a larger taxable income for United States tax purposes.⁴³

While the Court in the *NCR* case ruled out the device of using the 902 credit for taxes on undistributed profits, it stipulated that the credit could be employed for crediting taxes other than the "standard tax."⁴⁴ This situ-

⁴⁰ The *Chicle* formula is:

$$\frac{\text{dividend}}{\text{"accumulated profits"}} \times \frac{\text{"accumulated profits"}}{\text{total profits}} \times \text{foreign tax} = \text{credit allowable}$$

⁴¹ E. Owens, note 5 *supra*, at 113.

⁴² The formula employed by NCR to achieve a credit with regard to its subsidiaries retained profits was:

$$\frac{\text{taxes paid by the subsidiary less the "standard tax" appropriate to the dividend}}{\text{X}} \times \frac{\text{"grossed up" amount of dividend}}{\text{subsidiary's "accumulated profits"}} \times \frac{\text{subsidiary's "accumulated profits"}}{\text{subsidiary's total profits}}$$

⁴³ *Id.*

⁴⁴ *National Cash Register v. United States*, 400 F.2d 820, 825 (6th Cir. 1968).

ation whereby the "Convention" and the 902 credit have been used together has been a difficult one to resolve. While the Court did not permit the use of the "Convention" "gross-up" in the 902 formula, it has been suggested that such a device should be permitted in conjunction with the "Convention." Noting that a withholding tax was to be included in the numerator of the fraction and that the "total profits" denominator was not diminished by subtracting that tax, it has been suggested that the British "standard tax," being a withholding tax, should be treated similarly.⁴⁵ The appellate court disagreed with this line of reasoning. It held that all taxes, including the British "standard tax," should be credited by the use of Section 902 (a) (1), thereby permitting NCR the tax saving advantage inherent in the use of this formula.⁴⁶

III. THE REVENUE ACT OF 1962: DOES IT PROVIDE A REMEDY AGAINST TAX SAVING?

According to one commentator,

There is . . . no reason why the burden level established by our tax laws should be lowered simply because the fiscal policies of other countries provide for lower taxes at the source. It is one thing for investors who operate abroad, and are therefore subject to two jurisdictions, to assert that the United States tax laws should not have the effect of making their income tax burden greater than the general United States level. But it is quite another matter for these investors to assert that because they operate abroad and are therefore subject to two jurisdictions they need not pay any tax at all.⁴⁷

With this philosophy in mind, Congress has attempted to resolve the inequities which resulted from the tax saving aspects of the 902 credit. In regard to this credit, the Revenue Act of 1962 has focused its attention on eliminating the saving feature which resulted when the foreign rate was lower than the rate of the United States.⁴⁸

Section 9 of the Revenue Act employs the use of the "gross-up"⁴⁹ technique similar to that utilized by the "Convention." In effect, the taxes that are to be "deemed paid"⁵⁰ by the domestic corporation are computed

⁴⁵ E. Owens, note 5 *supra*, at 372-73.

⁴⁶ It should be pointed out that § 902 (a) (1) did not always result in a greater saving to the domestic taxpayer than did the "Convention." The "Convention" provided a greater advantage when the "standard tax" rate had increased between the time the British subsidiary earned the income and paid the "standard tax" and the time that it distributed a portion of its accumulated income as a dividend. This was true because § 902 credit was based on the tax rate applicable at the time the subsidiary paid the "standard tax," but Article XIII (1) credit was based on the tax rate applicable at the time the dividend was paid.

⁴⁷ Surrey, *Current Issues In The Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 849 (1956).

⁴⁸ *Staff of House Comm. on Ways and Means*, 87th Cong., 2d Sess., LEGISLATIVE HISTORY OF THE REVENUE ACT OF 1962 (Comm. Print. 1967).

⁴⁹ INT. REV. CODE OF 1954, § 78.

⁵⁰ INT. REV. CODE OF 1954, § 902 (a) (1).

by allocating the total taxes paid by the foreign subsidiary to the "accumulated profits" of the foreign corporation. However, unlike the definition given to "accumulated profits" in the pre-1962 section, "accumulated profits" for the purposes of the "gross-up" is the amount of the foreign corporation's income "without reduction" of the amount of foreign taxes paid in regard to such profits.⁵¹ This "gross-up" procedure is unlike the technique employed by the "Convention" in that it is more inclusive than the "Convention." While the "Convention" Article XIII (1) only limits the amount to be added to the dividend to the British "standard tax," the revised 902 credit permits a *gross-up of all the taxes* paid by the foreign corporation. The Code states that the taxes to be included are any "income, war profits, or excess profit taxes."⁵²

After this amount has been computed it is then allocated to the amount of dividend actually received by the corporate shareholder on the basis of the portion of "accumulated profits" paid to the parent. (For this purpose the definition of "accumulated profits" is the same as the pre-1962 code: profits in excess of such income taxes⁵³). The amount of tax allocable to the dividends actually received by the domestic shareholder is the amount of foreign tax deemed paid by the shareholder. If the foreign rate is lower than the corporate rate of the United States, then the difference between these on the "grossed-up" dividend is the amount paid in U.S. taxes by the domestic corporate shareholder.⁵⁴

⁵¹ INT. REV. CODE OF 1954, § 902 (c) (1) (A); actually the total amount of the foreign taxes will be allocated to "accumulated profits" because these profits will normally be the total amount of the foreign corporation's profit upon which the foreign taxes were imposed.

⁵² INT. REV. CODE OF 1954, § 902 (a) (1).

⁵³ *Id.*

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						Old Law	New Law "Gross Up"
Operation of foreign Corporation							
Total earnings of foreign corporation						\$100.00	\$100.00
Less: foreign taxes at 30% rate						30.00	30.00
After tax earnings distributed to U.S. shareholders (cash)						<u>70.00</u>	<u>70.00</u>
Income of U.S. shareholder							
Cash distribution						70.00	70.00
Plus: "Gross Up"						-	30.00
Total U.S. shareholder income						<u>70.00</u>	<u>100.00</u>
U.S. shareholder tax liability							
Tentative U.S. tax on distribution at 48% (disregarding surtax)						33.60	48.00
Less: foreign tax credit							
old law	$\frac{70}{70}$	X	$\frac{70}{100}$	X	30	21.00	-
gross up	$\frac{70}{70}$	X	30			-	30.00
U.S. tax payable						12.60	18.00
Plus: Foreign Tax paid						30.00	30.00
Total Tax Liability						<u>\$42.60</u>	<u>\$48.00</u>

Because foreign taxes paid by the foreign corporation are included in the income of the domestic taxpayer for U.S. tax purposes, there is no need for the *Chicle fraction*. Its only purpose was to offset some of the savings in tax credit which had resulted from the deduction of these foreign taxes. Instead, the foreign taxes paid by the subsidiary are multiplied against a fraction which results in a credit proportionate to the dividends actually received.⁵⁵ If the foreign corporation retains some of its earnings as was the case with both of NCR's subsidiaries, the taxes related to those undistributed profits will not be included in the credit resulting from these calculations.

The question of how the 902 credit will relate to pre-existing international tax treaties has been resolved by the Revenue Act itself. Prior to 1962, if there was conflict between the Code and a treaty, the treaty was to prevail.⁵⁶ However, Section 31 of the Act has reversed this priority, giving the 902 credit precedence over any other credit arrangement that might conflict.⁵⁷ Nevertheless, this conflict will not result with the British "Convention." Since the Revenue Act has already provided for a "gross-up" device with regard to the British "standard tax" through Section 78, the use of the 902 credit for other tax credits is not prohibited.⁵⁸ Moreover, it appears that the need for the credit afforded by Article XIII (1) of the "Convention" is no longer of value with regard to the British "standard tax," where the corporate domestic shareholder "owns at least 10 percent of the voting stock"⁵⁹ of the foreign corporation. The *Biddle* decision,⁶⁰ mentioned earlier, held that the British "standard tax," with regard to an individual shareholder, was a tax levied on the foreign corporation and not on the domestic individual taxpayer. As a result, the court did not permit the individual petitioner to obtain a code credit. *Biddle* did not preclude a corporate shareholder from qualifying for a 902 credit with regard to the "standard tax."⁶¹ Thus any domestic corporation owning at least 10 percent of the stock of a British corporation will find no particular advantage in splitting the foreign taxes to be credited between the "Convention" and Section 902 (a) (1). NCR if faced today with a situation similar to that it faced in 1958, would be able to employ Section 902 in obtaining a credit for all taxes in the same manner that it obtained credit for the "standard tax" through the use of the "Convention." Again, it must be em-

⁵⁵ *Id.* "foreign tax credit, (b)."

⁵⁶ INT. REV. CODE OF 1954, § 7852 (d).

⁵⁷ H.R. REP. NO. 1447, 87th Cong., 2d Sess. 96 (1962).

⁵⁸ Treas. Reg. § 1.78-1 (c) (1965) makes the "Convention" and the 902 credit with regard to the "standard tax" mutually exclusive.

⁵⁹ INT. REV. CODE OF 1954, § 902 (a).

⁶⁰ *Biddle v. Commissioner*, 302 U.S. 573 (1938).

⁶¹ *National Cash Register v. United States*, 400 F.2d 820, 825, n. 11 (6th Cir. 1968).

phasized, however, that it could not credit taxes paid by its British subsidiaries which relate to undistributed profits, *i.e.*, dividends that NCR does not, in fact, receive.

The reforms of the 902 credit have been excluded in application from all "less developed country corporations" (LDCC).⁶² That is, the "gross-up" provisions do not apply to the extent that dividends are paid by a foreign corporation out of "accumulated profits" of a year for which such a foreign corporation is a "less developed country corporation."⁶³ As to such distributions, there is no inclusion in the gross income of the United States corporate shareholder of taxes paid by the foreign corporation which the shareholder claims as a credit. The foreign tax credit is, therefore, computed in the same manner as it was prior to the 1962 legislation.

The justification for not extending the 1962 legislation to these "less developed country corporations" is based upon the same thinking that caused Congress to reform the 902 credit.⁶⁴ By using the "gross-up technique, it was believed that foreign investors would no longer be given an unfair advantage over domestic investors which had been a result of the tax saving qualities of the credit.⁶⁵ However, Congress felt that investment in less developed countries should be encouraged and permitted the pre-1962 credit to continue.⁶⁶

Despite the desire of Congress to end the tax advantages incurred by domestic taxpayers investing in the advanced countries of the world, there are still tax advantages which can be reaped through the use of the revised foreign credit. Many of these benefits occur where the foreign rate is above the U.S. rate,⁶⁷ and this condition does exist in many countries.⁶⁸ If the effective tax rate on the foreign corporate earnings is greater than the U.S. rate, a larger excess credit will result than if the "non-gross-up"

⁶² INT. REV. CODE OF 1954, § 902 (a) (1).

⁶³ Pursuant to INT. REV. CODE OF 1954, § 955 (b) (3), President Kennedy designated as "less developed countries" all foreign countries in existence after 1962 except Australia, New Zealand, Hong Kong, Japan, South Africa, the countries of Western Europe and the countries of the "Sino-Soviet" bloc, Exec. Order No. 11071, 3 C.F.R. ____ (Supp. 1962), 26 U.S.C. § 955 (c) (3) (1964).

⁶⁴ Stone, *supra* note 35 at 91.

⁶⁵ E. Owens, note 5, *supra*.

⁶⁶ In the case of the corporations deriving most of their income from less developed countries, however, your committee concluded that it would be inappropriate at this time to raise the effective rate of combined American-foreign tax since this would discourage new investments in such countries . . . to discourage such investments at this time would be contrary to our national policy. *United States Code Congressional and Administrative News* at 3371.

⁶⁷ W. Slowinski and T. Haderlein, *UNITED STATES TAXATION OF FOREIGN THE INCREASING ROLE OF THE FOREIGN TAX CREDIT*, (W. LaFave and P. Hay 1967) [Hereinafter cited as Slowinski and Haderlein].

⁶⁸ Examples of foreign rates for the developed countries are: Canada — 50%, France — 50%, Japan — 50%, Germany — 34 — 60%.

credit is used.⁶⁹ This excess credit resulting from both credits can be applied to future tax obligations under Section 904 which was incorporated into law in 1958.⁷⁰ Thus the "gross-up" legislation of 1962 may still provide a tax benefit for the domestic taxpayer investing in a developed country and also put the less advanced country investors at a disadvantage since they may not be able to incur the benefit of a large tax credit carryover.⁷¹

Since inequities and loopholes in the tax credit system still exist, the reaction of many corporations in the United States has been to create tax devices through which these foreign credits can be most beneficial. In fact it has been suggested that credit considerations are effective and important determinants in a corporation's business planning.⁷² For example, a United States corporation owning a subsidiary in India (a "less developed country corporation") may wish to benefit from the tax advantages of credit excess afforded by investment in countries whose corporate tax rate is higher than the U.S. rate. In order to do this, it is possible for the parent corporation to interpose a holding company, which is not a "less developed country corporation"⁷³ between itself and a direct investment in the less developed country, and thereby convert an investment for the purposes of Section 902 from an investment in a "less developed country corporation" into one which is not.⁷⁴

The strategic and planned use of alternative accounting procedures can also increase the tax benefits accorded the domestic investor in foreign operations when the foreign investment is a corporate subsidiary with a United States parent. While the Regulations require the preparation of accounting statements on behalf of foreign subsidiaries to be in accordance with generally accepted accounting principles of this country,⁷⁵ there is no requirement that accounting records of the foreign subsidiary be kept on the same basis as the domestic parent.⁷⁶ Therefore, by keeping two sets of books for the foreign corporation — one for tax purposes and one for business — the corporate taxpayer is able to utilize accelerated depreciation

⁶⁹	"Gross up"	Non "gross up"
Dividend (from gross income of 100)	40	40
Amount received in dividend under § 78	60	0
Total amount subject to US tax	100	40
Tentative US tax rate (48%)	48	19.20
Foreign tax credit under § 902 (a) (1)	60	24
U.S. Tax	0	0
Excess tax credit	12	4.80

⁷⁰ INT. REV. CODE OF 1954, § 902 (d).

⁷¹ Surrey, note 47 *supra*, at 840.

⁷² Slowinski and Haderlein, note 67 *supra*, at 151.

⁷³ A foreign holding company which receives less than 80% of its income from or has less than 80% of its assets located in less developed countries is not a "less developed country corporation."

⁷⁴ Slowinski and Haderlein, note 67, *supra*, at 143.

⁷⁵ Treas. Reg. § 1.964-1 (1964).

⁷⁶ Slowinski and Haderlein, note 67 *supra*, at 151.

techniques in order to arrive at the amount of taxable income for foreign tax purposes. But with regard to the financial records for use in the United States, these depreciation expenses are deferred and cause the foreign corporation to show high income. All of this is done prior to dividend distribution. By the time dividends are distributed, the effect of accelerated depreciation will have ceased to lower profits. Therefore foreign taxes will be higher. However, from the U.S. point of view, the deferred expenses will now accrue so that the corporate income of the foreign subsidiary will be lowered but not in proportion to the foreign taxes actually being paid. As a result of these manipulations, the resulting credit in foreign taxes will be much higher than the stated foreign income warrants.⁷⁷ The legality of these steps has yet to be contested.

IV. CONCLUSION

The history of the foreign tax credits of the United States, both unilateral and bilateral, has been a series of attempts to eliminate the inequities of the double taxation incurred by a U.S. citizen who desires foreign investment. While this development has generally resulted in more equitable treatment for the foreign investor, it has also given him several unwarranted advantages. The case of *NCR v. United States* has clearly shown that this country is increasingly wary of allowing the foreign investor such advantages. With a keen emphasis on the need for domestic growth, a dangerous situation rising in its balance of payments and a growing distrust of the efficacy of foreign aid in foreign relations, the United States is inclined to further restrict foreign investments. Perhaps the time will come when history will repeat itself and the foreign investor will once again find himself at a disadvantage in the American scheme of taxation.

J. Douglas Donenfeld

⁷⁷ For a detailed discussion of this procedure, see Slowinski and Haderlein, note 67 *supra*, at 151-52.